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UNDERWRITING

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Two centuries ago practically every business enterprise was carried on by a single individual or at most by a partnership. It was the time of individual effort, because every undertaking was planned upon such a modest scale that the need of some means by which the resources of a number of persons could be combined had not been seriously felt. The few corporations that existed served only to emphasize this fact. The resources of even the largest and most important of them would form a small fraction of the funds at the command of the average present day capitalist. No better illustration of this can be found than that furnished by the British East India Company. The capitalization of this corporation which ruled an empire, and to a great extent shaped the policy of England, was £400,000—less than one-fiftieth as large as that of the United States Steel Corporation.

So long as every investor was in a position to know the character and business integrity of his co-partners, the only risk involved was the usual business risk which still is to be faced in every industry. Even if a company was to be formed, nothing was done until the necessary subscriptions had been secured and a large percentage of them paid in.

There was one form of business activity, however, which greatly felt the need of some form of insurance against loss. The shipping industry was at that time one of the most risky enterprises into which one could embark. The dangers of disaster combined with the risk of capture by the cruisers of one or the other of the powers with which England was almost constantly at war, made it attractive only to the boldest. The profits were enormous, an owner often being able to clear the cost of his vessel in a few voyages. On the other hand, the losses when they occurred, were severe. The

profits of years might be wiped out in a day, and even the staunchest and most opulent merchants were often crippled by the loss of parts of their fleets.

Two centuries ago the man who had a cargo to send to the Mediterranean contrived to get rid of some of the risk by inducing a friend to take an interest with him. It was necessary to write out a statement of contract to which the guarantors subscribed; this was the first underwriting. These two men happened to be frequenters of Lloyd's coffee house in London, which was a favorite place for the merchants of the town to gather to discuss business, or to gossip. Others immediately saw the advantage of the scheme which their colleagues had devised, and on the next voyage the risk was parcelled out among a larger number of the patrons of the coffee house. Out of this small beginning has grown the great European maritime agency, still bearing the name of the humble coffee house proprietor, and which not only writes risks on vessels, but rates them and publishes their arrivals from every port the world over, no matter how small or how remotely situated.

As the size of business undertakings increased, the necessity for the co-operative form of organization began to be keenly felt. But the difficulty was that the risk involved in counting upon the payment of subscriptions when they fell due by stockholders, most of whom would naturally be little known to the promoters, was too great for the ordinary individual. He was anxious and willing to pay some one to assume this risk for him. Unless this could be done, it became practically impossible to undertake any great work without first having all the capital subscribed and a large percentage of it paid in—a practice which besides being very expensive, was almost impossible to carry through. As time went on and the size of corporations increased, promoters of enterprises found it was exceedingly difficult for them to market the securities no matter how good they might be. Outside of a small community they were practically unknown, and it required an enormous amount of work, and in fact it soon proved to be impossible to reach investors in distant localities, or to convince them of the advantages of a project which often it was impossible for them to visit. In their extremity the promoters turned to the banker, who, through his correspondents, could reach every important money centre in the world. The machinery to advertise and market the new securities was already in

existence and it was only necessary to convert it to the new use. Investors in distant localities would buy securities about whose value they knew little or nothing, because their bankers in whom they had confidence recommended them. In this manner, one hundred investors could be secured, where one would be obtained if the investor was forced to rely entirely upon his own judgment as to the profitability of the enterprise, the security of his lien, and the integrity and honesty of the officers.

The principle which underlies underwriting of industrial and railroad securities is the same that governs the marine insurance business of Lloyds. The syndicate or the marine agency guarantees to the railroad company or the ship owner that they will assume the risk in return for their commission. The owners are left free to turn their entire attention to the carrying out of their plans, being absolutely certain that the financiering of the scheme will require no attention on their part. Having thus briefly sketched the origin of the underwriting and ascertained the principles involved, we are now ready to take up the methods upon which the business is conducted to-day.

Roughly speaking, there are two classes of underwriters: first, there are those who simply insure the successful issue or sale of a security by some other person, and second, there are those who agree themselves to take the security. Let me cite you a practical illustration of the first kind of underwriting. In 1902 the Pennsylvania Railroad Company needed a considerable sum of money and proposed to issue \$75,000,000 of stock at the rate of 120 per cent., which would require the payment of some \$90,000,000. It would not do for them to fail. They had spent the money and must recoup their treasury. Besides the Pennsylvania Railroad plays such an important part in the affairs of the country, that failure would almost have been regarded as a national failure. The financial officers of the Pennsylvania Railroad Company know that the money market is very sensitive. One day everything may be tranquil, with confidence abounding, and money freely offered at a low rate; over night a great disaster, either real or impending, may throw the financial world into a tumult of excitement. It may be a great conflagration, such as that of Chicago or Baltimore, or some great financial institution which had hitherto been considered very strong

may be discovered to be in trouble, or possibly a great European war may be threatened by some such event as that recently occurring in the North Sea. The result would be that the success of any great financial transaction would be seriously jeopardized.

In consequence of this, bankers were asked what they would charge to insure the success of the issue. Such a large sum is more than one house is willing to risk; consequently, the bankers formed a syndicate or combination of capital. This differs from a corporation in the fact that while a corporation exists forever; a syndicate, on the other hand, ends when the transaction is over. The charges agreed upon were satisfactory to the Pennsylvania Railroad. The gentleman who made the contract with it, went back to his office in New York and took out of his records a list. That was his syndicate list—a list which he has formed by years of experience, and is virtually a “roll of honor.” It comprises the names of gentlemen whom his experience tells him are financially able to float the security, and whose word is as good as their bond. The banker makes a succinct account of what his terms are and what he is committing himself to do, and he sends this by cable to bankers in London, Berlin, Amsterdam, Paris, and other money centres of Europe, with the request that they send him word in the morning how much they want to take. He sends word to Philadelphia, Boston, Baltimore and other nearby cities, with a similar request. When it is ten o'clock on this side of the ocean it is three o'clock on the other side. He would be able to get returns on all his messages upon his arrival at his office the next morning. He takes a list then of the subscriptions he has received and adds it up. In this case he discovered that instead of having subscriptions to \$90,000,000 he had \$200,000,000; so he makes an allotment according to his own ideas.

All members of the syndicate, when allotments are made, will be sent an extended statement covering all the points of the case, which they sign. These syndicate agreements are founded on honor. Mutual confidence among their members is indispensable. The document is sent back to the syndicate manager, who has plenipotentiary power to do almost as he sees fit within certain lines. It must not be supposed, however, that the service of the underwriters is small or incommensurate with the amount of payment received. An insurance company which insures a merchant's goods for \$100,000 re-

lieves him of all anxiety. He may sleep soundly, though his place of business is burned. Similarly with the Pennsylvania Railroad stock issue. For a small commission the bankers agreed to pay out \$90,000,000 within a short period, no matter what events arose meantime to interfere with the state of the money market. That is a service worth speaking of. Of course, individual banking houses were careful not to subscribe for more than they could take care of in case of trouble.

Those who promote the syndicate, of course, keep part of the commission for themselves. They earn it in originating and managing the syndicate.

The second kind of underwriting syndicate may be formed when a corporation wants to sell \$30,000,000 or \$60,000,000 worth of bonds. The president of the corporation will go to a banker and ask him to underwrite the loan. The banker must be satisfied of the credit of the company and of the correctness of the statements that are made to him. He must be satisfied that it is such a loan as the market will take. He makes his terms and says when he shall pay for the bonds. He signs a contract to pay for that \$30,000,000 loan at a certain time. He goes through the same operation as before and forms a syndicate. If the loan is not sold before the time agreed on, the underwriters must pay the money. That is the risk which they take. If the issue is successful the members will get checks from the promoter of the syndicate as their proportions of the profit and the syndicate is now closed out; but no statements are rendered, neither are they expected.

We now come to the marketing of bonds. Bonds are generally marketed by the syndicate managers who are the members of the syndicate. There are generally one or two firms who are responsible for the marketing of the bonds and the underwriters do not have to take the bonds unless these persons are unsuccessful. In the case of the Japanese loan recently advertised in the papers, you saw a circular signed by Kuhn, Loeb & Co., the National City Bank and the National Bank of Commerce of New York. These institutions were, in this case, responsible for the marketing of the bonds.

Not all syndicates are successful, and it may happen sometimes, instead of taking profits, losses must be paid. Syndicates may not be closed up for several years. If they have been unable to sell the bonds at the time of their creation, or at the time of the formation

of the syndicate, the bonds sometimes become "stale" and difficult of sale.

The value of the service which the underwriting syndicate performs can scarcely be over-estimated. Without it the floating of large issues of securities would be almost impossible. The knowledge that a group of bankers stands ready to support and take the new issue themselves if they cannot dispose of it on favorable terms, gives confidence to every investor.